Germany: Staff Concluding Statement of the 2024 Article IV Mission

May 28, 2024

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC – May 28, 2024: *An International Monetary Fund (IMF) mission, led by Kevin Fletcher, and comprising Harri Kemp, Mustafa Saiyid, and Galen Sher conducted discussions for the 2024 Article IV Consultation with Germany during May 15 –28. At the end of the visit, the mission issued the following statement:*

The German economy is expected to begin a gradual consumption-led recovery this year as inflation continues to ease. Following four years of crisis management in response to the pandemic and Russian gas shutoff, economic policymaking is appropriately shifting focus toward medium-term challenges. In this regard, medium-term growth prospects could be bolstered by the following: further increasing public investment, including in the green transition and digitalization; offsetting the aging-related decline in the labor force, including by improving the availability of childcare and easing other obstacles to full-time work; enhancing the financing environment for start-ups and innovation; cutting red tape; and deepening economic integration within Europe. Continued prudent financial sector policies are also critical to contain risks.

Recent economic developments and outlook

1. The German economy has begun to recover following major shocks. High energy prices following the shut-off of Russian gas contributed to surging inflation during 2022-23, which in turn weighed on private consumption and economic activity. The impact of these shocks was, however, greatly mitigated by a strong policy response. In particular, the authorities provided income support to cushion the impact of higher energy prices while maintaining price signals that incentivized firms and households to conserve energy. Such conservation efforts, together with steps to secure access to new energy supplies, have helped return wholesale gas prices to more normal levels. Lower energy prices have in turn, together with monetary tightening, spurred rapid disinflation. Real wages are now growing, and the economy expanded in the first quarter of 2024.

2. Gradual recovery is expected to continue this year as inflation ease s further.

- ***Inflation*** is expected to continue falling in 2024 on subdued demand and as lower energy and food import prices continue to pass through to retail prices. Core inflation is projected to slow as well but remain above headline inflation, as services prices remain sensitive to robust wage growth.

- As real wages continue to rise, higher private consumption is expected to drive a modest and gradual recovery in 2024, with ***real GDP*** growing by around 0.2 percent, supported also by external demand. A return to growth is expected to gradually reinforce confidence, further bolstering consumption in 2025. Private investment is also expected to recover in 2025 on the back of improved demand and moderate monetary policy easing during 2024-25. As a result, GDP growth is projected to accelerate to between 1-1½ percent during 2025-26.

3. Over the medium term, rapid population aging is expected to slow economic growth and adversely affect public finances. As baby boomers retire and recent immigration waves subside, the annual growth rate of Germany's working-age population is expected to fall by around 0.7 percentage points—more than any other G7 country. These unfavorable demographics are projected to slow annual economic growth to around 0.7 percent over the medium term. An aging population will also adversely affect public finances as tax revenue growth slows and spending on pensions and healthcare rises.

4. Risks to the economic outlook are broadly balanced. Upside risks include the possibility that positive news and reduced uncertainty spur a faster-than-expected recovery in consumption and investment. Key downside risks include the potential for accelerating geoeconomic fragmentation, worsening global conflicts, and intensifying stress in global commercial real estate (CRE) markets. Uncertainty about the degree of price stickiness also poses risks in both directions to the pace of disinflation. Medium-term growth could also be higher or lower than expected if immigration flows differ significantly from baseline assumptions.

Fiscal policy

5. The fiscal stance is expected to tighten in 2024, as is required to comply with the debt brake. The cyclically adjusted primary balance is expected to contract by over 1 percentage point of GDP, driven by the phasing-out of energy-price support measures. Lost energy-price subsidies will be buffered by lower pre-subsidy energy prices, such that the net effect on activity is expected to be modest. The debt brake is also specified in cyclically adjusted terms, which allows some countercyclical flexibility in response to the modest growth outlook for 2024. Given weak domestic demand, the government should use this flexibility to the fullest, as planned, including by ensuring full implementation of the public investment budget.

6. Over the medium term, Germany faces rising spending pressures. In addition to the extra spending due to aging (¶3), Germany also faces rising pressures for defense spending. And, despite public investment having increased in recent years, investment needs remain large, with further substantial increases needed to upgrade infrastructure in transport, energy, communications, and other critical areas.

7. To accommodate rising spending needs, the authorities should consider moderately easing the debt brake. A well-designed fiscal rule helps to ensure that debt remains at sustainable levels. However, Germany's debt brake is set at a relatively tight level, such that the annual limit on net borrowing could be eased by about 1 percentage point of GDP while still keeping the debt-to-GDP ratio on a downward path. Such an easing would allow more room for much-needed public investment and other key priorities. Similarly, while the implementation of the EU's new fiscal framework is ongoing, early indications suggest that it may be preferable for Germany to choose the more gradual, 7-year adjustment period under the framework over the default 4-year period, considering the need to create fiscal room for public investment.

8. Reforms to reduce medium-term spending pressures and/or increase revenue are also needed.

- Adjusting the debt brake, as proposed above, would ease fiscal consolidation pressures but not fully address them. Credible medium-term fiscal plans and reforms to create fiscal room are therefore also needed to address these pressures and reduce policy uncertainty.
- Options that could be explored include eliminating environmentally harmful subsidies and tax expenditures, increasing the efficiency of public healthcare spending, raising taxes on real estate and on goods and services (as Germany's revenue from such sources is below the advanced-economy average), and/or closing loopholes in inheritance taxes.
- Reforms to the social security system could also significantly reduce strains on the government budget while shoring up the system's finances. Contribution rates in the pension, healthcare, and long-term care insurance systems are expected to increase in the coming years, as reserves are used up and expected spending growth outpaces expected growth of revenue. This could exacerbate labor market distortions. Benefits might also fall, which could fray the safety net for the elderly. Possible reforms to lessen such outcomes include indexing retirement ages to increases in life expectancy and indexing pensions-in-payment to inflation rather than to wages. Reforms that increase incentives to extend working lives would also help mitigate adverse economic growth effects from population aging.

Financial sector policies

9. Germany's banking and insurance systems have further strengthened their overall capital and liquidity positions. Higher interest rates boosted banks' interest margins and profitability in 2023. Macroprudential policy measures applied by the German national authorities have also strengthened capital buffers in recent years. Banks, in aggregate, had a common equity tier 1 capital ratio of 17.0 percent in 2023Q4 and liquidity coverage ratios of 157 percent for significant institutions and 185 percent for less-significant institutions. The median solvency capital ratio for the overall insurance sector is also substantial at 330 percent.

10. However, bank profitability is expected to ease somewhat going forward, and CRE risks are elevated. Profitability is expected to subside as deposit funding costs rise, causing net interest margins to decline. In addition, credit losses are rising from historically low levels, with losses rising especially in the CRE sector, which has been adversely affected by monetary tightening and structural changes in demand for urban offices and physical retail space.

11. Against this background, continued prudent financial sector policies are needed to contain risks.

- In the *near term*, the authorities should continue to closely monitor CRE-related risks of financial institutions; ensure that recorded valuations of real-estate assets remain current; encourage conservativism in capital distributions; and continue to review and test financial safety arrangements. For banks, in particular, the authorities should support efforts aimed at maintaining borrowers' ability to service loans, for example via maturity extensions for solvent borrowers, while requiring appropriate classifications of any modified loans and sufficient provisions against future loan losses. The authorities could also consider facilitating the conversion of CRE properties to other uses by, for example, easing zoning restrictions on their conversion to residential units. The authorities should also preserve existing macroprudential buffers, close gaps in data collection on lending standards for CRE loans, and pass legislation to add income-related borrower-based measures for residential mortgages to the macroprudential toolkit.

- Over the *medium term*, the authorities should consider a positive setting for the countercyclical capital buffer in normal times, as this would make a releasable capital buffer available when going from a neutral period to a downturn. In addition, a single deposit insurance scheme with a public backstop would strengthen system safeguards in case of liquidity risks.

12. Further efforts to improve banking sector profitability would also bolster financial stability. Some cost reduction could come from increased digitalization and automation of banking services, which would reduce the need for physical branches. Additional cost reduction could come from scale efficiencies achieved by consolidation of small banks, some of which is already taking place at a gradual pace domestically but could be accelerated on a cross-border basis by making further progress towards a common Banking Union in Europe.

Structural reforms

13. Recent reforms to enhance incentives for innovation and investment in Germany are welcome. The expansion of the tax credit for research and development in the Growth Opportunities Act will support innovation. Reforms under the Future Financing Act, including relaxed requirements for initial public offerings and allowing dual-class shares, will encourage the creation of startups by making it easier for entrepreneurs to realize returns when their companies are successful while allowing them to maintain some degree of control over company operations. The recent establishment of the German Growth Fund (*Wachstumfonds Deutschland*) will provide additional financing for startups both through public funds and by de-risking such investments for private investors.

14. To further boost productivity and entrepreneurship, the government should deepen efforts to cut red tape and promote digitalization. Unnecessary red tape remains an important constraint on productivity. For example, the World Bank's *Enterprise Surveys* suggests that it takes significantly longer to obtain a business operating license in Germany than in other advanced economies. These delays are likely related to a lack of online government services. More generally, Germany lags behind other EU countries in offering online government services to businesses—including items like registration or tax filing—and in pre-filling online forms. In this context, swift implementation of e-government plans, including the Online Access Act 2.0, will be important. And, while important progress has been made in digitalization (notably in 5G, which now covers 93 percent of households), further expansion is needed of fiber optic networks, which cover less than one-third of homes.

15. Deepening the European single market and Capital Markets Union is also critical to boosting Germany's growth prospects. Further efforts are needed to simplify the provision of cross-border services, recognize qualifications across member states, and harmonize accounting, tax, and insolvency rules, among other areas. Such deeper integration would allow Germany and other EU member states to better leverage economies of scale and gains from trade and specialization within the EU, foster competition, lower costs, enhance economic resilience, and boost productivity and growth. More integrated capital markets in Europe would expand financing opportunities for businesses, including innovative startups.

16. To stabilize labor supply, the authorities should ease constraints on women's working hours and lessen high effective marginal tax rates for some part-time workers.

- Women's labor force participation has improved substantially over the past two decades, although there are still 2 million fewer women in the labor force than men. Moreover, women are more than four times as likely as men to work part-time. The authorities should remove obstacles that prevent women who wish to work more hours from doing so. This means expanding access to full-day child- and eldercare and improving its reliability. Ways to reduce the effective marginal tax rate on second earners in married couples could also be explored.
- Some low-income workers face high effective marginal tax rates on additional income (i) due to reduced public benefit payments when their income increases and/or (ii) when the income of second-earners in "mini-jobs" exceeds the mini-job threshold (currently €538/month). Easing these high effective marginal tax rates could improve incentives for part-time workers to extend their working hours.

Such efforts to boost labor-force participation and working hours could notably increase the economy's growth potential, as will ongoing efforts to enhance worker skills and to facilitate the labor market integration of migrants.

17. Continued efforts are needed to meet Germany's ambitious climate mitigation targets. The authorities' latest projections indicate that, for the first time, Germany is on track to meet its 2030 emissions reduction target (but not its 2045 target) with policies that have already been implemented. These projections assume, however, an ambitious further acceleration in the rate of deployment of renewable power, from 7 percent annual growth during the past decade to 11 percent growth over the 2024-30 period. To help achieve this objective, the authorities have taken measures to streamline approval processes for solar and onshore wind projects and have increased subsidies for solar power. Further efforts along these lines would help meet climate targets—including measures to boost municipal planning capacity, limit extensions of deadlines, and digitalize approval processes with single points of contact—as would accelerated decarbonization efforts in building and transport sectors.

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The mission team thanks the authorities and all our other counterparts for their warm hospitality and the constructive dialogue.